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TAGS: EAIR ELTN ECPS ETRD EFIN CH
SUBJECT: CHINA EASTERN - SINGAPORE AIRLINES DEAL: BELLWETHER FOR CHANGE

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¶1. (SBU) Summary: On January 8, China Eastern Airlines (CEA) shareholders rebuffed a deal that would have allowed Singapore International Airlines (SIA) to buy a strategic share of the company. The move has sparked a wave of speculation regarding the meaning for CEA and the greater airline industry in China. The rejection occurred against the backdrop of maneuvering by CEA competitor China National Aviation Holding Corporation (CNAC) and new leadership at the General Administration of Civil Aviation of China (CAAC). Shanghai-based financial industry analysts said the move was a mix of capital market forces and the hand of the Chinese Government moving the industry towards consolidation, a hallmark of the new CAAC leadership. Shanghai-based airline executives believe the rejection was simply a manipulation by the competitor, and noted that the original government approval of the deal is a signal that the Chinese Government is still on a path of liberalization. The next move by CNAC and Beijing's reaction will be a good indicator of China's future direction on civil aviation reform. End Summary.

A Doomed Deal?

¶2. (U) Financial industry analysts with whom we met were not surprised by the rejection of the SIA-CEA deal by CEA shareholders. They noted that it was virtually impossible for the deal to be approved given that CNAC's and its supporters' (Cathay Pacific and Barclay Bank) combined votes surpassed the required one-thirds threshold to reject the deal. Expectations that CNAC would put a higher price on the table also caused investors to bid up the price of CEA shares, far past what was viewed as a reasonable price when SIA made its initial offer. This new price then led many minority shareholders to believe SIA's offer was too low.

¶3. (U) CEA and SIA began negotiations on the deal in 2006 and won government approval for it in September 2007. Under the deal, EAC would sell 1.75 billion shares (a 24 percent stake) to SIA and Temasek Holdings. This would be the first time a foreign entity was allowed to purchase strategic ownership in a Chinese state-owned airline. The purchase price of HKD 3.80 (USD .49) was close to the share price at the time CEA share trading was suspended in late May 2007. CEA shares virtually doubled in value following the announcement.

The Sharks Circle

¶4. (U) Soon after the deal was approved, Cathay Pacific announced plans to team up with Air China to block it. (Note: Cathay Pacific and Air China, along with Dragon Air have connecting ownership ties, which already makes them one of the strongest airline groupings in Asia. End note.) Cathay Pacific dropped its bid on opposition from Beijing. However, CNAC, the parent company of Air China, bought up CEA H shares, increasing its stake to 12.07 percent. Meanwhile CEA launched an effort to convince shareholders that the agreed upon share price (almost half the current market value) was still a fair price.

Add Some Political Intrigue

¶5. (U) On December 28, Air China and CNAC head Li Jiaxiang was promoted to Acting Minister of CAAC. Quickly following the appointment, CNAC announced it would offer a counter-bid of no less than HKD5 (USD .64) if minority share holders rejected the CEA-SIA deal. Cathay Pacific announced it would reconsider

teaming up with CNAC in the counter-offer. CEA issued a statement accusing CNAC of trying to mislead shareholders.

Deal Rejected by a Wide Margin

¶6. (U) Spurred on by the higher bid from CNAC, more than seventy seven percent of the H share holders and ninety four percent of the A share holders voted against the deal on January
¶8. Immediately after the rejection, CEA Chairman Li Fenghua stressed the importance of cooperation with SIA, reiterating his wish to adopt SIA's top-notch management skills and operation efficiency. Although CNAC is able to offer at least 40 percent higher per share and has more domestic resources to allocate to China Eastern, domestic carriers lack SIA's "software." Li will "continue to communicate with the national government and CAAC to work out a better restructuring plan for China Eastern." He publicly ruled out the possibility of merging with Air China.

SIA - The Biggest Loser

¶7. (SBU) The shareholder rejection negated two years of negotiation between CEA and SIA and will hamper SIA's plans to tap demand in China, where domestic flight demand is expected to increase fivefold by 2026, according to analysts of China's aviation market. SIA's original plan was to utilize China Eastern's base in Shanghai, and enable it to challenge Air China and Cathay Pacific inside China. According to media reports, SIA CEO Chew Choon Seng said on Dec 12 that the company will not raise its offer as "nothing is a must-have."

CEA Shareholders -- The Biggest Winners

¶8. (SBU) In discussions with ConGen, civil aviation market

analysts opined that a strategic alliance with Air China would be more beneficial to CEA by enabling it to expand market share outside of Shanghai. This belief has lead many investors to believe a rejection of the CEA-SIA deal would drive the stock price even higher. One analyst said "the biggest beneficiary of the bid rejection, however, will be the shareholders since they receive a counter-bid that is thirty to fifty percent higher." Other analysts noted that shareholders vetoed the deal because investors simply pay the most attention to the offer price. However, on news of the failed bid, shares of CEA immediately dropped 1.75 percent.

What About the Service?

¶9. (SBU) In a recent meeting with Econoff, CEA's management said the company's major competitive strategy is to compete by providing better service, rather than adjusting fares. CEA's goal on international flights is to improve its overall management skill and efficiency, which is why the company decided to partner with SIA in the first place. CEA needed an "infusion" of customer service skills to compete internationally. CEA management also hoped the partnership with SIA would also bring better customer service skills and management to their domestic flights as well.

¶10. (SBU) Besides looking to a deal with SIA, CEA outlined other measures it has taken to increase its customer service orientation. For example, CEA views the recent capacity sharing program with other carriers for the Shanghai-Beijing route as positive for the industry. This program was designed to offset negative effects from flight delays as consumers are free to get on the next available flight in this program. It also

alleviates many discounted tickets since all flights in the program must set their fares at similar rates and charge the same service fees. CEA operates 14 flights each day between Shanghai and Beijing.

Shanghai Analysts See Consolidation in the Future

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¶11. (SBU) In conversations with Congen, Shanghai financial industry analysts said they believe the Chinese Government was partially behind the rejection. They expect CEA will eventually merge with Air China to create a giant carrier, with 60 percent market share in Beijing and 50 percent market share in Shanghai. They opined that Air China could bring in a much better balance sheet than SIA. If they merge, their combined first year revenue could be as large as USD 500 to 700 million, compared with the USD 150 - 200 million under an SIA merger.

Other Shanghai-Based Airlines Say Liberalization on Course

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¶12. (SBU) The Contract and Planning Department Manager from Shanghai Airlines asserted that the rejection of the deal will negatively impact CEA, given the twenty-four percent stake purchase from SIA would have immediately lifted the book value, debt ratio and cash flow of CEA. Even though CNAC announced a higher counter-bid, he noted this offer is still not officially proposed through the China Securities Regulatory Commission (CSRC). He believes this is only a strategy from CNAC to influence minority shareholders to veto the SIA deal. The failure of the deal, however, would likely benefit Shanghai Airlines, since its major competitor in the Shanghai hub would not get bigger (Note: CEA has 41.1 percent market share in Shanghai versus Shanghai Airlines' 18.7 percent. End note). He was also skeptical that Air China could actually afford to acquire CEA. He doubted the Chinese Government intended an industry restructuring to combine Air China with China Eastern and China Southern, despite CAAC President Li Jiaxing's public

support for consolidating the industry.

China Still Welcomes Foreign Investment in Airlines

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¶13. (SBU) A top executive from Juneyao Airline, one of China's first fully private airlines, concurred that there would likely not be an industry restructuring resulting in a mega Chinese airline. The rejection was a result of "insider" maneuvering and some capital market forces that had driven the share prices beyond that of the initial agreement. He emphasized the move was not a result of government pushing for consolidation, or a backtracking on the path of liberalization and deregulation. Despite CAAC Acting Minister Li's arguments for consolidation, consensus in the government is still firmly in favor of improving Chinese airlines through allowing greater competition, citing the long deliberation process that resulted in approval of SIA's investment in CEA in the first place.

¶14. (SBU) The Juneyao executive maintained the Chinese Government still welcomes strategic investors that can increase competitiveness and the quality of Chinese airlines. Some government moves were misconstrued by outsiders and so they believe the government is moving in the opposite direction. He cited a 2007 move by the Chinese Government putting a moratorium on licenses issued for new private airlines. The stop was not a move by government to limit private competition but a direct result of bottlenecks created by a shortage of pilots and airport and air corridor space. China is expected to experience a shortage of 30,000 pilots in the next 3 to 5 years, and the demand created by new airlines had taxed the available pilots to the limit. It had become a safety issue because of

"overworked" pilots.

¶15. (SBU) The Juneyao executive said the Chinese Government will allow CEA's investors to make the final decision, but the Government's ultimate goal is still to bring foreign expertise and capital into China's airlines. He was quick to point out that the SIA deal was approved at the State Council level, not only CAAC. And, any potential deal with CNAC would also likely require the State Council's approval. Hence, CAAC Acting Minister Li's push for consolidation would be tempered. He also noted another reason that a deal with Air China is highly unlikely. Citing a personal relationship with the CEO of China Eastern Group, the holding company of CEA, he said the CEO is very much against any deal with Air China and would work to stop any such deal. As for impact on his own company, he said the result had no impact because Juneyao does not compete directly with CEA.

Background on CEA - One of China's Top Three Air Carriers

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¶16. (U) Established in 1997, CEA is one of the top three air carriers in China (the other two are Air China and China Southern). CEA is headquartered in Shanghai. Currently CEA operates a total of 423 routes, of which 299 are domestic routes, 19 are Hong Kong routes and 105 are international routes. It operates approximately 5,650 scheduled flights per week, serving a total of 136 foreign and domestic cities. The company's main aircrafts are Airbus A340, A 330, and A321 and Boeing 737 and 777. Among them, Boeing 737 and 777 are more focused on its domestic small cities routes while Airbus A340 is used for international flights. CEA also operates 5 Canadian Regional Jet aircraft and 5 Embraer Regional Jet aircraft to serve its Wuhan and Nanjing routes. CEA's main revenue (90 percent) is generated by passenger service and the remaining 10 percent from its cargo business.

CEA's U.S. Routes

¶17. (U) CEA's predecessor entity started Shanghai-Los Angeles service in 1991. That route was the airline's first route to a U.S. destination. Currently CEA provides daily flights on this route and it is one of CEA's most profitable routes. In 2006, CEA launched the world's first direct flight between Shanghai and New York. Presently the passenger load factor (PLF) is over 80 percent for this route. However, the first class and business class customer load on this route is still below the company's expectation. Hence, they plan to replace A340s on this route with Boeing 787s to reduce passenger capacity and increase its PLF. CEA also attributes its weak high-end passenger load on its NY route to an unsuccessful marketing strategy and the company will increase its marketing expense for this route in the future. Overall, CEA's major international markets are the United States and France.

Comment

¶18. (SBU) Comment: Most agree the CEA-SIA deal rejection was largely due to the high counter-bid price from CNAC and the resulting speculative current share price. It is also clear CNAC, as a partner of Cathay Pacific and a competitor of CEA, had a strong incentive to scuttle the deal. However, it remains unclear if and to what extent the government was involved and whether CNAC's move was merely a way to slow the competition, or whether it truly intends to work for consolidation of the major Chinese airlines. How Beijing reacts to CNAC's next move will provide light on how the Central Government will push civil aviation reform in the near term.
KJARRETT